

ST 07-7

Tax Type:

Sales Tax

Issue:

Exemption From Tax (Charitable Or Other Exempt Types)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS,

v.

ABC, INC.,
Taxpayer

No. 06-ST-0000

ID# 0000-0000

Sales Tax Exemption

Ted Sherrod
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General, George Foster, on behalf of the Illinois Department of Revenue.

Synopsis:

On January 27, 2006, the Illinois Department of Revenue (hereinafter the "Department") denied the second request of ABC, INC. (hereinafter "taxpayer") that the Department issue it an exemption identification number so that it could purchase tangible personal property free from the imposition of use tax as set forth in 35 ILCS 105/1 *et seq.* On April 25, 2006, the taxpayer protested the Department's decision and requested a hearing, which was held on January 5, 2007, with *Jane Doe*, Psy. D., the taxpayer's Chief Executive Officer, testifying. The sole issue to be determined at the hearing was whether the taxpayer qualified for an exemption identification number as "a corporation, society, association, foundation or institution organized and operated exclusively for

charitable ... purposes...[.] ” 35 ILCS 105/3-5(4). Following the submission of all evidence and a careful review of the record, it is recommended that the Department’s tentative denial of exemption be affirmed and finalized as issued.

Findings of Fact:

1. The Department’s jurisdiction over this matter and its respective position therein is established by the admission into evidence of Department Exhibit (“Ex.”) number (“No.”) 1.
2. The taxpayer was incorporated under the General Not-For-Profit Corporation Act of Illinois on October 22, 1992. Taxpayer’s Ex. No. 2. The corporate name indicated in the taxpayer’s Articles of Incorporation is XYZ, Inc. *Id.* The taxpayer is also known as ABC, INC., and has promulgated its by-laws under the latter name. Taxpayer’s Ex. No. 4.
3. The taxpayer’s organizational purpose, as enumerated in its Articles of Incorporation is to promote human growth and wellness among residents of the State of Illinois by providing substance abuse rehabilitation and substance abuse prevention and related educational and spiritual counseling. Taxpayer’s Ex. No. 2.
4. The taxpayer’s by-laws provide that its daily business affairs shall be managed by a Board of Directors, none of whom shall receive any salaries for their services. Taxpayer’s Ex. 4. However, Board members are authorized to receive a “fixed sum” in addition to reimbursements to cover expenses of attending Board meetings. *Id.* The by-laws do not provide for membership in the taxpayer or indicate that the taxpayer shall have any members. *Id.*
5. Taxpayer has no capital stock or shareholders and does not pay any dividends. *Id.*

6. The taxpayer obtained an exemption from federal income tax on October 11, 2000. The Internal Revenue Service granted this exemption pursuant to section 501(a) of the Internal Revenue Code (“Code”), based upon its determination that the taxpayer qualified as an organization described in section 501(c)(3) of the Code. Hearing Transcript (“Tr.”) pp. 9, 10; Taxpayer’s Ex. No. 1, Ex. No. 3.
7. The taxpayer’s office is located at Anywhere Street, Anywhere, inside the Medical building. Tr. p. 11.
8. The taxpayer furnishes a variety of substance abuse related and other health and counseling services. Tr. pp. 10-15. These services include substance abuse treatment services provided on an individual and group basis to approximately 100 clients weekly, and outpatient ex-offender treatment services for convicted sex offenders and persons convicted of driving under the influence of alcohol provided to approximately 125 clients weekly. *Id.*
9. The taxpayer provides counseling to persons convicted of driving under the influence of alcohol (“DUI counseling”) and sex offender treatment and counseling services only to clients that have been referred to the taxpayer by County agencies, the Secretary of State’s office or various court systems. Tr. pp. 14, 15.
10. The taxpayer assesses fees for all of the aforementioned services except its substance abuse treatment and counseling programs. Tr. pp. 12, 13, 21-25. The cost of the taxpayer’s substance abuse treatment and counseling services are not charged to clients, but are paid by the Illinois Department of Human Services, Division of Alcoholism and Substance Abuse (“DASA”). Tr. pp. 10-12, 17, 18. Pursuant to this funding, the taxpayer is authorized to provide substance abuse services only to

indigent residents of Chicago. *Id.* Moreover, this funding can only be used to provide substance abuse treatment and counseling. *Id.*

- 11.** DASA authorizes the taxpayer to provide such services only to persons determined to be indigent, and the provision of these services is restricted to persons falling within this classification. *Id.* The record does not indicate who makes the final determination that persons are indigent and therefore eligible for participation in the taxpayer's substance abuse program, or what criteria are used to make this determination.
- 12.** Fees for services charged to clients are based on the client's income, financial situation and other considerations affecting the client's ability to pay. Tr. pp. 21-30. Consequently, fees for these services are set on a sliding scale where the client can show that it cannot afford the maximum fee assessed. *Id.*
- 13.** DUI counseling clients ordinarily pay for these services. Tr. p. 13. Fees charged DUI clients, meeting state mandated standards showing that they are indigent and unable to pay, are paid from a fund for drunk driver indigents established by the state. Tr. pp. 13, 27-29.
- 14.** A majority of the costs of outpatient sex offender treatment services are paid by the County agencies responsible for probation and the provision of social services pursuant to a contract entered into between the taxpayer and these agencies. Tr. pp. 14, 21. Clients must pay any portion of these fees not covered by government agencies. *Id.* The percentage of service costs charged each client is determined by the county agencies that refer sex offender clients to the taxpayer. *Id.*; Tr. pp. 21 –

23. While these fees may be waived, the taxpayer is not authorized to waive the entire fee without the permission of the government. *Id.*
15. The taxpayer also provides space to Alcoholics Anonymous and Narcotics Anonymous. Membership in Alcoholics Anonymous and Narcotics Anonymous groups meeting at the taxpayer's facility is not confined to persons that are clients of the taxpayer. Tr. p. 12.¹
16. In 2005, the taxpayer paid 58% of its annual revenues of \$230,323 in salaries and professional fees. Taxpayer's Ex. No. 5. In 2004, the taxpayer paid 62% of its annual revenues of \$159,992 in salaries and professional fees. *Id.*
17. In 2005, the taxpayer's annual revenue was \$230,323 and its annual expense was \$222,095. Approximately 67% of the taxpayer's revenue in 2005 came from government sources. The remaining 33% of taxpayer's revenue came primarily from client fees charged for the taxpayer's services. Taxpayer's Ex. No. 5.
18. In 2004, the taxpayer's annual revenue was \$159,992 and its annual expense was \$160,364. Approximately 46% of the taxpayer's revenue in 2004 came from government sources and the remaining 52% of the taxpayer's revenue came primarily from client fees charged for the taxpayer's services. *Id.*
19. The taxpayer received 5%-6% of its revenues from fundraising in 2005, and 1%-2% of its revenues from fundraising in 2004. *Id.*

¹ The record contains no documentary evidence and little other information regarding the nature of the use of space at the taxpayer's offices by Alcoholics Anonymous and Narcotics Anonymous, or the terms pursuant to which this space is provided by the taxpayer. Consequently, the record in this case is insufficient to permit an analysis of the taxpayer's relationship with these groups as a factor in determining whether the taxpayer qualifies for a tax-exempt identification number.

Conclusions of Law:

The Retailers' Occupation Tax Act imposes a retailers occupation tax ("ROT") on persons engaged in the business of selling at retail tangible personal property. 35 ILCS 120/2. A "sale at retail" means any transfer of the ownership of or title to tangible personal property to a purchaser, for the purpose of use or consumption, and not for the purpose of resale in any form as tangible personal property to the extent not first subjected to a use for which it was purchased for valuable consideration ... [.]” 35 ILCS 120/1. The Use Tax Act imposes a use tax ("UT") on the privilege of using in this State tangible personal property purchased at retail from a retailer. 35 ILCS 105/3.

The taxpayer seeks an exemption number permitting it to purchase tangible personal property at retail without incurring use tax. The mechanism in the Illinois statutes for procurement of an exemption identification number for ROT purposes is found at 35 ILCS 120/1g, entitled "Exemption identification number." That section of the statutes states: "On or before December 31, 1986, except as hereinafter provided, each entity otherwise eligible under exemption (11) of Section 2-5 of this Act and on and after the effective date of this amendatory Act of the 92nd General Assembly each entity otherwise eligible under exemption (9) of Section 2-5 of this Act shall make application to the Department for an exemption identification number." Exemption eleven (11) of section 2-5 of the ROTA (35 ILCS 120/2-5(11)) states:

§ 2-5. Exemptions. Gross receipts from proceeds from the sale of the following tangible personal property are exempt from the tax imposed by this Act:

... (11) Personal property sold to a governmental body, to a corporation, society, association, foundation, or institution organized and operated exclusively for charitable, religious, or educational purposes, or to a not-for-profit corporation, society, association, foundation, institution, or organization that has no compensated

officers or employees and that is organized and operated primarily for the recreation of persons 55 years of age or older. A limited liability company may qualify for the exemption under this paragraph only if the limited liability company is organized and operated exclusively for educational purposes. On and after July 1, 1987, however, no entity otherwise eligible for this exemption shall make tax-free purchases unless it has an active identification number issued by the Department. 35 ILCS 120/2-5(11).

Therefore, the only way that the taxpayer can qualify for an exemption number pursuant to this provision is if it is a government body, a charitable, religious or educational entity, or a not-for-profit entity that is organized and operated primarily for recreation of persons age 55 or older.

The taxpayer seeks to qualify for an exemption identification number as a “corporation, society, association, foundation or institution organized and operated exclusively for charitable ... purposes [.]” 35 ILCS 105/3-5(4); 35 ILCS 120/2-5(11). The sole issue in this case is whether the evidence presented by the taxpayer establishes that it qualifies for the exemption number it seeks.

The first step in determining whether the taxpayer qualifies as an “institution of public charity” is to examine the language of its organizational documents. Morton Temple Association v. Department of Revenue, 158 Ill. App. 3d 794, 796 (3rd Dist. 1987). The taxpayer’s Articles of Incorporation state *inter alia*, that it is organized, and is to be operated exclusively, for charitable purposes. Taxpayer’s Ex. No. 2. However mere “statements of the agents of an institution and the wording of its governing documents evidencing an intention to [engage in exclusively charitable activity] do not relieve such an institution of the burden of proof that ... [it] actually and factually [engaged in such activity].” Morton Temple Association, *supra* at 796. Therefore, “it is

necessary to analyze the activities of the [taxpayer] in order to determine whether it is a charitable organization as it purports to be in its charter.” *Id.*

A similar rationale applies to the taxpayer’s showing that it is exempt from federal income tax pursuant to sections 501(a) and 501(c)(3) of the Internal Revenue Code. Tr. p. 10; Taxpayer’s Ex. No. 3. This exemption, standing alone or taken in conjunction with the statement in the taxpayer’s Articles of Incorporation, does not establish that the taxpayer actually operates for exclusively charitable purposes. *Cf. People ex rel County Collector v. Hopedale Medical Foundation*, 46 Ill. 2d 450, 464 (1970). Moreover, while this exemption establishes that the taxpayer is a “charity” for purposes of section 501(a) pursuant to the federal government’s determination that it meets the criteria set forth in section 501(c)(3) of the Internal Revenue Code, these sections of the federal income tax law do not preempt section 35 **ILCS** 105/3-5(4), 35 **ILCS** 120/2-5(11), or other statutory provisions governing Illinois sales and use tax exemptions. Consequently, neither the taxpayer’s federal tax exemption, nor the statement contained in the taxpayer’s organizational document concerning its charitable purpose, are dispositive of its entitlement to exemption from use and related taxes under Illinois law.

As noted earlier, the Department denied the taxpayer’s request for issuance of an exemption identification number on January 27, 2006. Department Ex. No. 1. The Department’s initial tentative denial of the taxpayer’s application for an exemption identification number is presumed to be correct, and the taxpayer has the burden of clearly and conclusively proving that it is entitled to the exemption. See Wyndemere Retirement Community v. Department of Revenue, 274 Ill. App. 3d 455, 459 (2nd Dist.

1995); Clark Oil & Refining Corp. v. Johnson, 154 Ill. App. 3d 773, 783 (1st Dist. 1987). To prove its case, a taxpayer must present more than its testimony denying the Department's determination. Sprague v. Johnson, 195 Ill. App. 3d 798, 803, 804 (4th Dist. 1990). The taxpayer must present sufficient documentary evidence to support its claim. *Id.* Moreover, it is well-settled that tax exemption provisions are strictly construed and all doubts are resolved in favor of taxation. Heller v. Fergus Ford, Inc., 59 Ill. 2d 576, 579 (1975).

In both ROT and UT matters, the Illinois courts apply the same criteria when determining whether a given taxpayer is an exempt organization as is applied for purposes of making this type of determination under the Property Tax Code (35 ILCS 200/1-1 *et seq.*). Yale Club of Chicago v. Department of Revenue, 214 Ill. App. 3d 468 (1st Dist. 1991).² The criteria to be applied in determining whether a given taxpayer is an exclusively charitable organization were first articulated by the Illinois Supreme Court in Methodist Old Peoples Home v. Korzen, 39 Ill. 2d 149, 156-57 (1968). In Methodist Old Peoples Home the Illinois Supreme Court set forth five factors to be considered in assessing whether an organization is actually an institution of public charity. To qualify, an organization should (1) have no capital stock or shareholders; (2) earn no profits or dividends, but rather derive its funds mainly from public and private charity and hold such funds in trust for the objects and purposes expressed in its charter; (3) dispense charity to all who need and apply for it; (4) provide no gain or profit in a private sense to any person connected with it; and (5) appear to place no obstacles of any character in the

² In Yale Club of Chicago v. Department of Revenue, 214 Ill. App. 3d 468 (1st Dist. 1991), the court analyzed the taxpayer's claim for educational and charitable exemptions under the Retailers' Occupation Tax Act according to the body of case law developed for analysis of property tax exemptions.

way of those who need and would avail themselves of the charitable benefits it dispenses. Methodist Old Peoples Home, *supra* at 157.

These factors are not rigid requirements. Rather, they are to be considered with an overall focus on whether, and in what manner, the institution benefits an indefinite number of people, or serves the public interest and lessens the burdens of government. DuPage County Board of Review v. Joint Commission on Accreditation of Healthcare Organizations, 274 Ill. App. 3d 461 (2d Dist. 1995). Moreover, an institution need not provide any direct financial assistance to individuals to qualify as a charity. In Methodist Old Peoples Home, the Supreme Court stated “charity is a gift to be applied ... for the benefit of an indefinite number of persons, persuading them to an educational or religious conviction, for their general welfare – or in some way reducing the burdens of government.” Methodist Old Peoples Home, *supra* at 157 (citing Crerar v. Williams, 145 Ill. 625 (1893)).

Applying these guidelines, I find that the taxpayer meets several of the criteria for determining whether it possesses common characteristics of a charity. Specifically, the record indicates that the taxpayer has no capital stock or shareholders. Taxpayer’s Ex. No. 4. Moreover, there are no provisions in the organization’s by-laws for the payment of dividends of any kind to the management of the organization or others. *Id.*

The record in this case indicates that the taxpayer provides outpatient ex-offender treatment services to convicted sex offenders pursuant to a contract to provide such services with County government instrumentalities supervising probation and social services. Tr. pp. 14, 21. Recipients of these services are ordinarily required to pay at least a portion of the fee for them charged by the taxpayer. *Id.* Counseling services are

also provided to persons convicted of driving under the influence (“DUI counseling”) that are referred to the taxpayer by various government bodies including County agencies responsible for probation and social services, the Secretary of State and various court systems. Tr. pp. 14, 15. The cost of these DUI counseling services is primarily borne by the taxpayer’s clients. Tr. p. 13. However, the cost of these services is subsidized by the state in the case of persons found by the state to be indigent. Tr. pp. 13, 25-29. In sum, funding for all of the aforementioned services is derived either from fees charged to clients by the taxpayer or pursuant to payments made under contracts negotiated with various government agencies.

The taxpayer also provides substance abuse counseling and treatment services to indigent residents of Anywhere. Tr. pp. 10-15. While the taxpayer’s CEO described the source of funding for this program as a “grant” from the Department of Human Services, Division of Alcoholism and Substance Abuse (“DASA”), the taxpayer did not submit a copy of the contract or agreement pursuant to which these funds are provided into the record. Consequently, the taxpayer has failed to show that this funding is not pursuant to a fee for service contract negotiated at arms-length with DASA. Sprague, *supra* at 803, 804.

Given the foregoing, the taxpayer’s primary barrier to exemption under the criteria enumerated in Methodist Old Peoples Home is its failure to prove that its funding is from public or private charity rather than from fees for services. Amounts paid as client fees in exchange for the provision of services are obviously not charitable contributions, but rather payments received by the taxpayer in the ordinary course of the taxpayer’s business. Moreover, the taxpayer presumably obtained the government

contracts and funding that generate most of the taxpayer's revenues through arms-length negotiations in the commercial market place to provide its services. Consequently, in the absence of documentary evidence to the contrary, the revenues the taxpayer receives from them must be characterized as government payments for services rendered rather than voluntary donations. In sum, based on the record presented in this case, the revenues generated by client fees and by the taxpayer's contracts and agreements with government agencies must be deemed to be attributable to revenues from business transactions rather than charitable sources specified in Methodist Old Peoples Home.³

While the courts have stated that the source of funds should not be a decisive factor "where it is established that the funds and property are devoted to public purposes" (American College of Surgeons v. Korzen, 36 Ill. 2d 340, 348 (1967)), the record also indicates that the taxpayer does not allocate any of the revenues it earns to free care or to providing services to persons that are unable to pay client fees assessed by the taxpayer. Rather, the taxpayer's audited financial statements that are included in the record indicate that the taxpayer applies all of such revenues toward funding internal operations.⁴ Taxpayer's Ex. No. 5. In this sense, the present matter parallels a line of decisions wherein exemptions were denied because the respective records lacked evidence of any charitable disbursements or supported a conclusion that such expenditures were *de*

³ The record indicates that the taxpayer also dispenses revenues from fundraising events by providing food and transportation to indigent clients of its programs. Tr. pp. 11, 12. However, these activities were incidental to the taxpayer's programs rather than a primary focus of its activities. See Tr. p. 30; Taxpayer's Ex. No. 5 (indicating that between 1% and 6% of its revenues were derived from fundraising during 2004 and 2005).

⁴ The taxpayer's CEO testified that some services to indigent clients that are not covered by client fees or government payments are discounted below the cost of services or in some instances are provided without charge. Tr. pp. 22-25. She also testified that it uses client fee revenues to pay for food and transportation services. Tr. p. 12. However the taxpayer has provided no documentation to substantiate these claims. Consequently, I have accorded no weight to this testimony. See Sprague, *supra* at 803, 804.

minimis. Rogers Park Post No. 108 American Legion v. Brenza, 8 Ill. 2d 286 (1956); Albion Ruritan Club v. Department of Revenue, 209 Ill. App. 3d 914 (5th Dist. 1991); Morton Temple, *supra*.

Another guideline from Methodist Old Peoples Home is that a charity provides services to all who need or apply for it. The taxpayer's Chief Executive Officer attempted to show that this guideline has been met through testimony that the taxpayer has written policies and procedures for waiving a portion of its fees for some of its services where it determines that service recipients are indigent even where the government refuses to pay for such services from funds it provides for indigent relief. Tr. pp. 27-30. However, none of these written policies were introduced into the record. Moreover, the taxpayer's Chief Executive Officer failed to enumerate the process through which it determines whether a service beneficiary is unable to pay for the taxpayer's services. Also, there was no testimony as to specifically how many people that were unable to pay (or qualify to have payments made on their behalf by the government) were helped by the taxpayer at no charge or at a reduced fee rate. *Id.* Since it is unclear from the record before me whether, under the taxpayer's guidelines, all persons that are unable to pay nevertheless qualify to receive the taxpayer's services, there is insufficient evidence to support a finding that the taxpayer places no obstacles in the way of those who would avail themselves of the taxpayer's benefits and provides service to all who need and apply for them.

The record in this case does not establish that the taxpayer's activities benefit an indefinite number of people. Testimony presented at the hearing in this case establishes that: (1) at least 25% to 30% of the taxpayer's funding comes from County government

instrumentalities, with this funding being contingent upon the provision of services to persons that are referred to the taxpayer by the government (Tr. p. 14); and (2) the taxpayer's DUI counseling and sex offender counseling and treatment services are available only to persons that are able to pay all or a portion of the normal fee for them or that qualify for government assistance pursuant to standards established by the government (Tr. p. 13). Again, no government contracts were introduced into the record. As a consequence, the record does not show whether government subsidies are available to all persons that need the taxpayer's services but are unable to pay for them. Moreover, the taxpayer introduced no documentary evidence indicating whether, and to what extent, it provides services to all such persons who do not receive government assistance. It is clear from these facts that the taxpayer has failed to prove that its programs serve an "indefinite number of persons" because the service provided by the taxpayer indicated in the record is limited to those that are able to pay or that qualify for government subsidies. Consequently, based upon the evidence presented, one must conclude that the taxpayer provides services to a limited class of persons, namely those that qualify for government assistance within parameters established by the government, and persons that are able to pay for the taxpayer's services.

An additional guideline from Methodist Old Peoples Home is that a charity not provide gain or profit in a private sense to any person connected with it. The taxpayer clearly would not meet this criterion if it were determined that compensation paid to the taxpayer's executives was so high that they could be considered the primary beneficiaries of the taxpayer's activities. Lutheran General Health Care v. Department of Revenue, 231 Ill. App. 3d 652, 661 (1st Dist. 1992). On this point, the financial information

provided by the taxpayer fails to conclusively show that the fees it earns from providing services do not inure primarily to benefit officers and others engaged in managing the organization.

These financials show that, of the total revenue earned in 2004 and 2005, over half was paid out as salaries and professional fees. Taxpayer's Ex. No. 5. The overall level of compensation does not appear to be unreasonable in light of the nature of services the taxpayer provides and the number of persons to whom these services are provided if one assumes that these expenditures are not disproportionately allocated to management. However, although there was testimony that Board members received no benefits from serving on the Board (Tr. p. 10), the by-laws provide for such benefits,⁵ and there are no documents in the record to support this oral testimony. Absent proper documentation, testimony that benefits were not disproportionately given to management alone is wholly inadequate for me to conclude that the compensation paid to the taxpayer's management was reasonable. Sprague, *supra* at 803, 804. Based on the evidence presented, I am unable to determine whether or not the taxpayer is providing gain or profit in a private sense primarily to managers connected with the organization.

I do not doubt that the taxpayer provides an extremely valuable service to its client population. However, grants of tax exemption are not based upon the value of the service being provided alone because each grant of exemption deprives the entire community of funds needed to provide other necessary services to everyone. Thus, as

⁵Board members are authorized to receive pay for their services apart from reimbursements to cover reasonable costs of attending Board meetings. Accordingly, the taxpayer's by-laws do not preclude the receipt of benefits for serving on the taxpayer's Board. See Finding of Fact No. 4.

discussed above, tax exemption is the exception rather than the rule, and statutes providing exemptions must be strictly construed in favor of taxation.

Taken as a whole, the preceding analysis establishes that the taxpayer has failed to establish that it qualifies as an institution of public charity in light of criteria enumerated in Methodist Old Peoples Home and other applicable case law. Therefore, the Department's determinations that denied the taxpayer's exemption identification number should be affirmed.

Ted Sherrod
Administrative Law Judge

Date: February 9, 2007